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IN THE

Supreme Court of the United States

October Term, 1975

No. 75-1718

UNION PACIFIC RAILROAD COMPANY,

Petitioner,

—v.—

THE UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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IN THE

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No.

UNION PACIFIC RAILROAD COMPANY,
Petitioner,

—v.—

THE UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Union Pacific Railroad Company prays that a writ of certiorari issue to review certain determinations of the United States Court of Claims sitting en banc, embodied in its Opinion and Findings of Fact entered October 22, 1975, with respect to which rehearing was denied February 27, 1976.

Opinion Below

The Opinion of the Court below is reported at 524 F.2d 1343 (1975), and the Opinion together with the Findings of Fact are reported at Ct. Cl. . The entire Opinion and Findings of Fact pertinent to the determination below with respect to which certiorari is now sought are set forth in a separate Appendix B, submitted herewith.

Jurisdiction

The jurisdiction of this Court is invoked under 28 U.S.C. §1255(1), and as the basis for the exercise of that jurisdiction, Rule 19 of the Rules of this Court.

Questions Presented

1. Whether the decision below so far departs from the accepted standards of judicial regularity so as to call for the exercise by this Court of its supervisory jurisdiction over the Court of Claims pursuant to Rule 19 of the Rules of this Court.

2. Whether the decision of the Court below with respect to the issue of valuation, being based on conclusions which are contradicted by its Findings of Fact and on conclusions for which no findings have, or, on the record, could have been made, is erroneous as a matter of law.

3. Whether the Court below erred, as a matter of law, when it determined that market prices on the New York Stock Exchange constituted the proper method of valuing 100 percent of petitioner's outstanding common and preferred shares when:

a. Qualified expert witnesses for both parties, and the Trial Judge, specifically rejected the use of stock market as the proper method of determining such value; and

b. There was no evidence in the record, nor did the Court below make findings of fact, to support this method of valuation.

4. Whether the Court below erred, as a matter of law, when it determined that market prices on the New York Stock Exchange constituted the proper method of valuing the shares in issue, when this method of valuation was proposed for the first time by respondent in a post-trial brief to the Court below as an alternative to the method of valuation contended for by it in its pleadings, and adopted by its witness at trial.

5. Whether the Court below erred, as a matter of law, when it rejected the uncontroverted and unimpeached testimony of a qualified expert witness as to the dates upon which the witness valued petitioner's common and preferred shares, without making any findings of fact to support such rejection, and substituted therefor its own opinion as to when it thought he determined such value, again without the necessary findings of fact.

6. Whether the Court below erred, as a matter of law, when it adopted as fact virtually the entire substance of the testimony of a qualified expert witness as to the proper method of valuation in its Findings of Fact but refused to consider such testimony in determining its valuation.

7. Whether the deduction for "interest" referred to in Section 711(a)(2)(B) of the Internal Revenue Code of 1939 includes amortized bond discount and call premium, and unamortized bond discount with respect to bonds reacquired.

8. Whether, in construing a Federal statute, the Court below erred as a matter of law, in ignoring this Court's determination in *Commissioner* v. *National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134 (1974), as to the state of the law regarding the nature of the deduction for bond discount and premium at the time Congress enacted such statute.

9. Whether the Court below erred, as a matter of law, in dismissing, as "an ambiguous legislative incident," the rejection by a Conference Committee of the Senate and House of a proposed amendment to the statute being construed, which amendment would have required the specific adjustment which the Court below upheld.

10. Whether the Court below erred, as a matter of law, when it ignored the legislative history which accompanied the enactment of the Korean War Excess Profits Tax Act, which specifically mandated that the adjustment sought by respondent below with respect to bond discount and premium must be made, but noted that no such adjustment was required under the statute herein being construed.

Statutes and Regulations

Pertinent parts of Sections 23(b), 710, 711, 712, and Sections 714 through 719 of the 1939 Internal Revenue Code, together with pertinent portions of Sections 29.22(a)-17, 29.23(b)-1 of Treasury Regulations 111, and Sections 1.61-12(c)(3) and Section 1.163 of the Treasury Regulations on Income Tax (1954 Internal Revenue Code) are set forth in Appendix A, *infra,* pp. 36-48.

Statement

Petitioner brought this suit for refund of income and excess profits tax for the taxable year ended December 31, 1942. The issues with respect to which a writ of certiorari is sought involve a determination of petitioner's excess profits tax credit based on equity invested capital, and petitioner's excess profits tax net income under the World War II Excess Profits Tax Act. The first issue, the valuation issue, concerns the proper method of valuing Union Pacific Railroad's common and preferred shares issued incident to its reorganization in 1898, and its reacquisition of the Oregon Short Line Railroad during 1899-1901. The second issue, the bond discount and premium issue, involves a determination as to whether, at the time Section 711(a)(2)(B) of the 1939 Code was enacted, it was then the law that bond discount and premium were deductible *only* as "interest" and not as "loss" or "expense."

The Valuation Issue

The valuation issue concerns the proper method of valuation to be utilized to determine the fair market value of Union Pacific's common and preferred shares issued on January 31, 1898, for all the property of its predecessor, Union Pacific Railway Company, as well as 273,493 of its common shares issued during the 1899-1901 period in exchange for all the outstanding shares of the Oregon Short Line Railroad. The value of these shares is material to a determination of petitioner's excess profits tax credit based on equity invested capital under the World War II Excess Profits Tax Act.

On its excess profits tax return for the year in issue petitioner claimed a value for these shares of $100 per share (the par value), or an aggregate value of $163.3 million. On audit of petitioner's return, the petitioner's per share value was reduced to $75, or an aggregate value of $122.5 million. During the post-audit stage of this case, the Commissioner of Internal Revenue (the "Commissioner") further reduced the value of these shares to an aggregate of $79.5 million. Petitioner paid the resulting deficiency, and brought this suit in the Court below for a refund.

In its petition to the lower Court, and at trial through the testimony of its expert witness, petitioner contended that the preferred shares had a per share value at issuance of $100, and that common shares had a per share value at issuance of $175-$200, or an aggregate value of $251.7 million. Respondent, by way of offset pleaded in an amended answer, attacked as too high the Commissioner's value, and asserted that the shares had an aggregate value of $57.5 million, a value to which its expert witness testified during the course of the trial below. Both parties maintained their respective positions during the course of trial and in their briefs to the Trial Judge.

In his Findings and Opinion the Trial Judge considered the method of valuation utilized by respondent's witness on the merits, and thoroughly rejected his opinion as to value, mainly because he failed to take into account the foreseeability of specific factors at the time of the reorganization, the foremost of which was that the primary purpose of the reorganization was the reconstitution of the system which had been dismembered during the separate receiverships of its component companies.

On the other hand, the Trial Judge concluded that petitioner's expert utilized an incorrect valuation date, and therefore refused to consider his testimony on the merits.

The Trial Judge concluded that the fair market value of the shares in issue, determined on the basis of concessions made by respondent's witness, was so close to the value determined by the Commissioner that neither petitioner on its refund claim, nor respondent on its offset, were entitled to recover on this issue.

Neither party advocated a method of valuation based on stock market prices, either at trial or in their briefs to the Trial Judge. The Trial Judge concluded[1] that such method of valuation was not appropriate in this case and his Findings of Fact were consistent with this conclusion. A valuation based on contemporaneous stock market prices was raised for the first time by respondent in its post-trial brief to the Court below. These values were stipulated for the sole purpose of providing points of reference for the expert witnesses, and were neither introduced nor relied upon by either party as a reliable measure of value.

The Court below adopted, almost in their entirety, the Findings of Fact of the Trial Judge, finding that the reintegration of the Union Pacific system was foreseeable at the time of its reorganization, and finding that certain specific facts would cause the contemporaneous stock market to undervalue the shares in question. As to subsequent

1. Reported at 36 AFTR 2d 75-5776, CCH 1974 Standard Federal Tax Rep., Vol. 9, ¶ 7902.

periods of time, the Court found that the stock market again failed to reflect the dramatic improvement in value of Union Pacific's shares.

The Court below further found that the method of valuation utilized by respondent's witness was improper, and concluded, in addition, that he utilized an incorrect valuation date for the reorganization shares.

Finally, the Court below reversed the Trial Judge and concluded that stock market prices were the proper measure of the value of the shares in issue.

The Bond Discount and Premium Issue

Petitioner, and its subsidiaries, in computing net income on their consolidated income tax returns for the taxable years 1940 and 1941, and petitioner in its separate income tax return for the taxable year 1942, took deductions for amortization of bond discount, unamortized bond discount for bonds reacquired, and call premium, as "expense" and "loss" respectively, and not as "interest."

The Commissioner, on audit, accepted petitioner's treatment of these deductions. However, by way of setoff in the Court below, respondent asserted that bond discount and expense constituted "interest," within the meaning of Section 711(a)(2)(B) of the 1939 Code, a position which, if sustained, would increase petitioner's excess profits tax net income.

Petitioner contended below that a review of the state of the law in 1942 governing the nature of the deductibility of bond discount and premium, as recited by this Court in its decision in *Commissioner* v. *National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134 (1974), together with an examination of the statute involved here, indicated that these items were then properly deductible as "expenses" and/or "losses." Petitioner further contended that since the legislative history of the statute in issue included the

rejection by a Conference Committee of the Senate and House of a Senate amendment which would have specifically mandated the adjustment sought by respondent below by way of setoff, it is clear that the Congress did not consider these items to constitute "interest" within the meaning of Section 711(a)(2)(B).

The Court below sustained respondent's position, without reference to this Court's decision in *National Alfalfa, supra,* dismissed as "ambiguous" the legislative history which accompanied the enactment of the statute under consideration, and further ignored, without comment, the legislative history of the Korean War Excess Profits Tax Act.

Reasons for Granting the Writ

The Valuation Issue

1. The decision of the Court below so far departs from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision within the meaning of Rule 19 of the Rules of this Court.

Due to the unique status of the Court of Claims, as a trial court whose decisions are reviewable only by this Court, certain legal principles respecting the interplay between that Court's findings of fact and its conclusions of law have been established by this Court to govern the regularity of its determinations. Thus, this Court has held that:

1. A decision of the Court of Claims will not be sustained to the extent it is not supported by that Court's specific findings of fact which, unaided by its conclusions of law or opinion, clearly support such decision. *United States* v. *Causby,* 382 U.S. 256, 267-268 (1945); *United States* v. *Esnault Pelterie,* 299 U.S. 201, 205-206 (1936); and *United States* v. *Seminole Nation,* 299 U.S. 417, 422 (1936);

2. The findings of fact in the Court of Claims establish the facts in the same manner as a jury verdict. *Crocker* v. *United States,* 240 U.S. 74 (1916); *Stone* v. *United States,* 164 U.S. 380 (1896). See also annotation to *Saalfield* v. *United States,* 62 L. ed 895;

3. The ultimate findings of fact of the Court, containing no *evidentiary* findings on the issue under consideration, cannot prevail when they come into direct conflict with the evidentiary findings. *United States* v. *Penn Foundry & Mfg. Co.,* 337 U.S. 198, 213 (1949); and

4. Under the predecessor to 28 USCA 1255, 62 Stat. 928, c. 646,[2] failure of the Court of Claims to make findings of fact on a material issue constitutes grounds for a review of the decision by this Court. *United States* v. *Causby, supra,* 267-268.

The decision on valuation so far departs from the aforesaid standard of judicial regularity so as to demand review by this Court in the exercise of its power of supervision over Court of Claims' determinations, inasmuch as it (1) *is based on conclusions which are CONTRADICTED by the findings, and* (2) *is based on conclusions for which no findings have been made, or on the record could have been made.*

Conclusions Contradicted by Findings

Noting that the findings of the Court below are controlling, and also noting that the Court below recognized that the valuation issue is a factual one, citing *American Steel Foundries* v. *United States,* 153 Ct. Cl. 234 (1961), petitioner invites this Court's attention to the following absolute

2. In this respect, petitioner notes that the statutory requirement regarding findings of fact by the Court of Claims, while no longer contained in the statute was omitted upon revision, as unnecessary. Historical and Revision Notes to 28 USCA § 1255.

contradictions of the conclusions below by the findings below.[3]

Findings of Fact	*Conclusions*
1. The Court found that defendant's expert, whose valuation was rejected as too low, assigned a minimum value of $32 per share to the reorganization common stock. [Findings 336(b), p. 191, 397(b), pp. 224-225.]	The Court concluded that the value of these shares, based on stock market prices, was $26.625. [Slip Opinion, p. 28.]
2. The Court rejected as too low, an expert's value of $72 per share for 3,688 shares of acquisition stock. [Finding 419(b), p. 235.]	The Court concluded that the value of these shares, based on stock market prices, was $50.50 per share. [Slip Opinion, p. 68.]
3. The Court found that defendant's expert's value of $112 per share for 2,636 shares of acquisition stock should be rejected as too low. [Finding 424(b), p. 238.]	The Court concluded that the value of these shares, based on market prices, was $91.50. [Slip Opinion, p. 68.]
4. The Court found that there were specific factors peculiar to Union Pacific as it emerged from reorganization which would cause a substantial under-valuation of its shares by the stock market when first traded in 1898. [Finding 360(b), p. 202.]	The Court concluded that "rather than being of doubtful worth in estimating the value of the U.P. stock, the market serves as its most accurate indicator." [Slip Opinion, p. 66.]

3. Page references are to the Slip Opinion set forth in Appendix B hereto.

Findings of Fact	*Conclusions*
5. The Court found that the drop of stock market averages in March were not to be regarded "as reflective of enduring value but rather as hesitations or reactions from the strong opening in January and February" [Finding 360(b)(2), p. 203]; and that the drop in March "* * * was a natural reaction from the opening, and was not a consequence of substantive negative factors." [Finding 355(b), p. 200.]	The Court concluded that its determination of value based on stock market prices is not unduly pessimistic because "notably, the value of U.P. common and preferred actually fell during 1898 before climbing again." [Slip Opinion fn. 49, p. 69.]
6. The Court found that the use of stock market prices in 1898 for the common and voting trust certificates of Oregon Navigation Company to determine the value of its common and preferred shares held by Oregon Short Line must be rejected as "an unwarranted adoption of stock market prices as the fair market value for large blocks of stock." [Finding 406(b), p. 228.]	The Court held that stock market prices were the proper measure of value of: 100 per cent of Union Pacific's common and preferred stock on February 2, 1898, and of the Union Pacific common shares issued to secure a 100 percent interest in Oregon Short Line. [Slip Opinion, pp. 67-68.]
7. The Court found that a value of $55.7 million for the Oregon Short Line, even without regard to its value as part of the Union Pacific System, must be rejected as too low. [Finding 406(b), p. 228.]	The Court held that, based on stock market prices, the value of Union Pacific's investment in the Oregon Short Line, represented by its common stock issued for 100 percent of the Oregon Short Line, was $12.8 million. [Slip Opinion, p. 69.]

Findings of Fact	*Conclusions*
8. The Court found that "valuations based on such standards as net assets * * * are in the circumstances of the U.P. not legitimate starting points for a determination of fair market value" and therefore cannot be supported as a proper method of valuation even if an "excess" is added. [Finding 385(b), p. 219.]	The Court concluded that its value based on stock market prices was supported by "the net assets values placed in the record by defendant * * * plus a 15 percent estimate for going concern value and good will * * *." [Slip Opinion, p. 69.]
9. The Court found: that, Union Pacific's plan of reorganization "was a good one and successful, and made it possible for the U.P. to proceed to profitable operation, free of the burdens of its past." [Finding 291(b), p. 170.]; and that "The reorganization meant a great improvement in the condition of Union Pacific at the time of the reorganization in 1898." [Finding 295, p. 171.] The Court further found a great value to Union Pacific of the agreements to reacquire the Oregon Lines, finding: "* * * reacquisition * * * was of the utmost importance to the reconstitution of the pre-receivership U.P." [Finding 297, p. 172]; that "reacquisition * * * was therefore essential to protect the position of the U.P." [Finding 332, p.	The Court concluded: "While the reorganization and acquisition agreements themselves may have added some value to the U.P. stock (a main concern of Judge Kashiwa's dissent in *Bankers Trust*) it does not appear to be significant here." [Slip Opinion, p. 66, in fn. 43.]

Findings of Fact	*Conclusions*
185]; and that "The reacquisition was of great value to the U.P. * * * And aside from the Oregon Lines' ability to make money on their own mileage, they were * * * most strategic and essential for the U.P. * * * [and] were undoubtedly of great value to U.P." [Finding 335(b)(3), p. 190.]	
10. The Court found that: reacquisition of the Oregon Lines "was of the utmost importance to the reconstitution of the pre-receivership U.P." [Finding 297, p. 172.]; "it was the underlying intention and plan of those prominent in the affairs of the U.P. * * * to reconstitute the U.P. network." [Finding 298, p. 172]; "The significance of the acquisition of the Southern Pacific * * * was foreseeable; and the reasonably aware investor could appreciate the context —the management's continuing and successful efforts to reconstitute the Union Pacific System * * *." [Finding 319(b), pp. 179-180]; "* * * the foreseeability of growing earnings from a reconstituted U.P. free of Government restrictions, in an era of rising national prosperity, made the market	The Court concluded in ultimate Finding 238, p. 153: "The concept of a reconstitutive-reorganization, the basis for the valuations by plaintiff's expert, has no merit whatsoever * * *."

Findings of Fact

evaluation not a 'liberal' index of its value" [Finding 355(b), p. 200.]; "Because it was to such a degree foreseeable that * * * the U.P. System would be substantially reconstituted and have good and increasing earnings, it is concluded that the low part of the range * * * was * * * severely depressed * * *." [Finding 360(b), p. 203.]; "The valuation * * * suffers * * * from a failure to recognize the imminence of the reconstitution of the U.P. system * * *." [Finding 368(b), p. 209.]; "It is found that the foregoing * * * [is] * * * rejected * * * as * * * giving too little weight to * * * the significance of the essential position of the Oregon Short Line and Oregon Railroad and Navigation in the reconstitution of the U.P. system * * *." [Findings 397(b), pp. 224-225, 406(b), p. 228, and 407(b), p. 229.]

Conclusions

11. The Court found: that "the returning wave of prosperity began in 1896 * * * was underway at the time of the reorganization * * * in 1898." [Finding 304, p. 174.]; "Improvement in the very first years and the foreseeability in January 1898 of

The Court concludes that "Two factors which give us pause in considering stock market values are the 'pessimistic' nature of the market in 1898-99, and the likelihood of reacquisition of the Oregon stock at the time of the reorganization. While these factors might possibly cause some doubt

Findings of Fact

improvement brought about by Harriman are the subject of following findings." [Finding 306, p. 175.]; "Correctly judging that the depression had run its course in 1896 or 1897 and would soon be followed by a new wave of prosperity, Harriman's first venture * * * was a renewal * * * of U.P.'s plant." [Finding 307, p. 175.]; "Harriman proved to be right in his views that the Union Pacific should prepare for coming prosperity before its rivals * * *." [Finding 307, p. 176.]; * * * the reasonably aware investor could appreciate * * * the management's continuing and successful efforts to reconstitute the Union Pacific System, in a setting of increasing national prosperity." [Finding 319(b), p. 180.]; the conclusions as to Harriman constitute " * * * an effort without basis to deprive the valuation of the U.P. stock of the value of Harriman's talents and successes." [Finding 322(b), pp. 180-181.]; "The prospects of this improvement were to a degree foreseeable * * * in January 1898 * * * in the financial community, which knew of Harriman's talents and had witnessed since 1896 his in-

Conclusions

as to the reliability of market evaluation, we find that, in the instant case, they do not. The pessimism of investors in the then current economic situation was well-founded. The nation had undergone a severe depression, and recovery was not a foregone conclusion. In addition, the U.P. itself had recently undergone bankruptcy and was in the process of reorganization. Its total mileage had shrunk, and it had no West Coast outlet. The only factors which gave the U.P. any value at all were the possibility of economic recovery and reacquisition of branch lines lost during bankruptcy. We conclude that rather than being of doubtful worth in estimating the value of the U.P. stock, the market serves as its most accurate indicator." [Slip Opinion, p. 66.]

Findings of Fact

creasing degree of leadership of the U.P." [Finding 324, p. 181.]; "As of January 31, 1898, reacquisition * * * of the Oregon Lines * * * was substantially certain * * *." [Finding 335 (b), p. 189.]; and "The nondividend paying quality of the stock was in the past. * * * these were stocks whose past was past. The road had reasonably hopeful prospects for the future * * *. The low part of the range * * * was 'an unduly and severely depressed one,' if only because it may well have been based on the recency of reorganization and the lack of present dividends * * *." [Finding 360(b)(1)-(2), p. 202.]

Conclusions

12. In rejecting the contention that the fact that "market value of U.P.'s securities in later years—even less than a year after the reorganization—turned out to be substantially greater than around the time of the reorganization," had no bearing on the value of the railroad "when it emerged from the protection of the courts," the Court found: "The steady rise in market prices reflected enhancements in value not so unforeseeable as defendant's

The Court concluded: The average between high and low market values on February 2, 1898, represents the most accurate value for the reorganization stock." [Slip Opinion, p. 67.]

Findings of Fact

expert testified. The upturn dated from 1896 and Harriman correctly judged the improvement business conditions. The prospects for profits and the enhancements in the value soon to come after January 1898 could be appreciated at that time by a reasonably informed investor * * *." [Finding 359(b)(2), pp. 201-202.]

Conclusions

Conclusions For Which No Findings Have Been Made

As noted, the failure of the Court of Claims to make findings of fact on material issues constitutes grounds for review of its decision by this Court. *United States* v. *Causby, supra,* 267-268. In arriving at its resolution of the valuation issue, the Court below reached many conclusions for which it made no findings.

The Court held, at Slip Opinion, p. 65, as a matter of law, that for stock market prices to be a proper measure of "fair market value," the following facts must first exist:

1. There must be a willing buyer and a willing seller;
2. Neither party to the sale is under a compulsion to buy or sell;
3. Both buyer and seller are reasonably informed as to all the relevant facts; and
4. The shares must be freely traded in an open and organized market.

Despite this holding, no findings were made with respect to any of these factors. In fact, in the light of findings which were made, the lack of findings as to these matters is

critical. For example, in the absence of a finding to the contrary, petitioner submits that it is highly unlikely that the sellers of the shares were reasonably informed as to all the relevant facts concerning Union Pacific's reorganization, including: the fact that the returning wave of prosperity began in 1896 and was thus under way at the time of the reorganization [Finding 304, p. 174]; the influence of the genius of Harriman [Findings 305-325, pp. 174-183.]; the absolute certainty, from the outset, that the Oregon Lines would be reacquired by the reorganizers of Union Pacific as an integral part of such reorganization [Findings 326-335, pp. 183-191.]; the continuing and successful efforts of Union Pacific's management "to reconstitute the Union Pacific System in a setting of increasing national prosperity." [Finding 319(b), pp. 179-180.] Certainly these were factors which would cast doubt on the reliability of stock market quotations as a proper measure of the value of 100 percent of the outstanding stock of a corporation. In this regard see *Moore-McCormack Lines, Inc.* v. *Commissioner*, 44 T.C. 745 (1965), acq. 1968-1 C.B. 2.

In addition, the Court below cited its own decision in *Bankers Trust Co.* v. *United States*, 518 F.2d 1210 (1975), for an analysis of those situations 'in which stock market values are not accurate value determinants." [Slip Opinion, pp. 65-66.] In footnotes 42 and 43 [Slip Opinion, p. 66] the Court recited these situations to be:

> (1) If the market is too thin to absorb the shares offered for sale; (2) if too few sales are made to place any reliance on the validity of the prices commanded; (3) if restricted stock is sold; (4) if an agreement not to resell exists; (5) if so many shares are sold that supply exceeds demand and a "blockage discount" must be accounted for, or finally, (6) if the stock prices increase as a result of the agreement to sell, then the market valuation of the stock

> may be inadequate. *Bankers Trust, supra,* Slip Opinion at 14-20.
>
> In all instances, there were sufficient sales to indicate the reliability of the market price determinations, yet not so many sales as to indicate the usefulness of determining any "blockage" factors.
>
> While the reorganization and acquisition agreements themselves may have added some value to the U.P. stock, (a main concern of Judge Kashiwa's dissent in *Bankers Trust*) it does not appear to be significant here.

Again, there are no findings to negate the existence of any of these factors, which would invalidate the use of stock market prices. In fact, as to the value of the reorganization and acquisition agreements, the findings expressly contradict the Court's conclusions.

Finally, the Court below, without benefit of citations or findings, concluded that "stock market provides a 'black and white' unbiased and contemporaneous measure of the value of the U.P stock." [Slip Opinion, p. 66, fn. 44.] Not only are there no findings to support this conclusion, but the Court below has made findings to the contrary, which findings establish that stock market prices cannot be used to "measure the value of the U.P. stock." For example, in Finding 360(b), p. 202, the Court found that the fact that Union Pacific had just recently emerged from reorganization, and the fact that its new shares paid no dividends, were factors which would cause an undervaluation of its shares by the stock market in 1898.

2. Petitioner has been severely prejudiced by the adoption by the lower Court of a method of valuation first raised by respondent in its post-trial brief to that Court.

In adopting stock market as the proper measure of the value of the shares in issue the Court has severely preju-

diced petitioner's rights. As noted, this method of valuation was first proposed by respondent as an alternative contention in its post-trial brief to the Court below.

In its pleadings, and during the course of trial, respondent contended for the method of valuation proposed by its witness, a valuation method which rejected the use of stock market prices. Petitioner, on the other hand, through its witness also rejected the use of market prices. In fact, stipulated stock market prices were before the Court in order to facilitate computation of price/earnings and price/dividend ratios.

However, faced by the Trial Judge's total rejection of its witness, respondent in its brief to the full Court raised market prices as an alternative method of valuation. Petitioner respectfully submits that it was clearly prejudicial to require it to refute this method of valuation after trial. In deciding the land sales issue, the lower Court held that it was a fatal defect for petitioner to have raised a new contention concerning such issue in a reply brief to the Trial Judge. [Opinion, pp. 34-6.]

If the raising of contentions in a reply brief to a Trial Judge results in "unthinkable" prejudice to one party to this proceeding, how much greater should such prejudice be where contentions are raised in a brief to the full Court? The same principles of fundamental fairness should be equally applied to both parties in this proceeding. See *Baird* v. *Commissioner*, 438 F. 2d 490, 493 (3rd Cir. 1970), wherein the Court held that "it would be patently unfair to decide this case on a theory of which taxpayer was unaware and thus did not have an opportunity to meet at the evidentiary stage." See also *Comm'r* v. *Transport Mfg. & Equip. Co.*, 478 F. 2d 731, 736 (8th Cir. 1973), where the Court found substantial prejudice where a contention was first raised in a post-trial brief.

While the evidence of record clearly establishes that stock market prices are not reliable measures of value in the

instant case,[7] had petitioner been aware, at or prior to trial, that respondent would contend for this method of valuation in its brief to the Court, it would have focused its direct and cross-examination on this issue and could have produced additional expert testimony and/or evidence on this point. In the posture of the valuation issue at trial, with both litigants contending that stock market prices were not an appropriate measure of value, it would have been an abuse of judicial process for plaintiff to have spent any time in attacking the use of this valuation measure.

3. The Court below has held as a matter of law that stock market prices are determinative of fair market value.

The failure of the Court below to find facts in support of its conclusion that stock market prices govern the question of fair market value,[8] and the absence in the record of evidence which would support such findings, demonstrate conclusively that the Court has held that as a matter of law stock market prices are determinative of fair market value.

Despite the fact that the Commissioner and the United States are one and the same,[9] the Court as between them

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7. Not once during the thirty-three year history of this case has the market been deemed a proper basis for valuing the shares in issue, having been rejected: by plaintiff in its return; by the examining agent on audit; by the Appellate Division on review; by the Commissioner; by defendant; by defendant's witness; by plaintiff's witness; and finally by the Trial Judge. In the face of such total rejection, this Court's adoption of stock market prices, advanced by defendant at the eleventh hour, most certainly cannot stand.

8. As noted, both expert witnesses testified that stock market prices were not reliable. Accordingly, it was clearly erroneous for the Court below to arbitrarily substitute its own unsupported opinion with respect to a matter in which it has no knowledge or expertise. *Loesch & Green Construction Co.* v. *Commissioner*, 211 F. 2d 210 (6th Cir. 1954); *Alvary* v. *U.S.*, 302 F. 2d 790, 794 (2d Cir. 1962).

9. See, e.g., cases involving the foreclosure by collateral estoppel of a taxpayer's attempt to litigate the question of civil fraud after his conviction for criminal fraud, such as *Amos* v. *Commissoner*, 43 T.C. 50, 52 (1964), aff'd. 360 F. 2d 358 (4th Cir. 1965).

attached a presumption of correctness to the Commissioner's determination. The Court's conclusion that this presumption must be overcome by both parties to this proceeding, aside from being a novel theory, results in there being three parties litigant herein, the plaintiff, the defendant, and the Commissioner of Internal Revenue.

In any event, the conclusion below that the presumption was overcome by the presence in the record of stipulated stock market prices, in effect, attributes to such market prices an independent legal significance. The Court goes even further in holding that such market prices were sufficient to meet defendant's burden of going forward on its offset claim.

The Court explained its holding, as follows:

> "Stock exchange quotations automatically take some cognizance of many valuation factors. For example, good will; the nature of the business and history of the enterprise; the economic outlook in general and that of the specific industry in particular; estimate of dividend paying capacity; and sales of similar stocks. Most importantly, the stock market provides a "black and white" unbiased and contemporaneous measure of the value of the U.P. stock." [Slip Opinion, p. 66, fn. 44.]

This holding is totally unique, and is a clear departure from accepted methods of valuation.

The Court thus held that stock market prices, without more, are sufficient to carry a litigant's burden even though:

> a) The shares being valued constitute the taxpayer's entire outstanding capital stock;
>
> b) The taxpayer had just emerged from receivership, and the nation was emerging from a severe depression;

> c) The market wherein the shares were traded was the New York Stock Exchange on a single day in 1898;
>
> d) Trust receipts representing a mixture of common and preferred stock, rather than the taxpayer's common stock, were the commodity traded on the exchange; and
>
> e) While the taxpayer's dividend paying history was poor, its reorganization had freed it of the onerous restrictions responsible for its financial problems.

These factors alone are so unique as to make the application of any fixed formula for valuation immediately suspect, especially when coupled with the fact that no findings were made as to how the market was affected by such factors. This newly minted theory of valuation must be rejected in this, and any other, valuation case.

Only qualified expert witnesses are competent to evaluate the reliability of current stock market quotations, *a fortiorari* an unregulated market in 1898. Here the qualified expert witnesses testified that they were not reliable. The Court of Claims cannot reject that testimony out of hand.[10]

Petitioner respectfully submits that if under these circumstances, it was not error for the Court of Claims to seize upon market prices as the "most accurate" measure of the fair market value of all of the new Union Pacific Railroad Company shares, such a standard will necessarily be applied, as a matter of law, in the future to questions involving the valuation of major enterprises. Certainly, such a standard will be adopted by the Court of Claims for the purpose of valuing railroad systems. If stock market price automatically overcomes the product of lengthy study by experts, the distortions of a unique and abnormal

10. Petitioner reiterates that many of the findings made by the Court below specifically refute the reliability of stock market prices.

moment in the Company's history, and the risks inherent in the unregulated market place of 1898, then surely market price, derived from a modern regulated market, will measure value without exception.

The adoption of this new rule of valuation is of broader importance than the denial to petitioner herein of a reasoned and fair judicial determination.

For example, this Court recently held that the Court of Claims under the Tucker Act will be the exclusive forum for the initial determination of all substantial valuation claims against the United States made by stockholders and bondholders of railroad systems which have been assimilated into the Consolidated Rail Corporation. ("Conrail") *Regional Rail Reorganization Act Cases,* 419 U.S. 102 (1974).

Unless the writ herein sought issues, the Court of Claims will be compelled by the force of the instant valuation decision, to employ this simplistic presumption with respect to all future litgants, greatly compounding what petitioner believes to be a completely unsound result, and causing difficulties which might well be avoided or minimized by a timely pronouncement by this Court. It was a gross error for the Court below to equate "fair market value" to "stock market price", without necessary findings and evidence to warrant such an equation, and in the face of evidence indicating the fallacies in such an equation. This error, which will be compounded to the detriment of other litigants over many more years of litigation in connection with Conrail alone, should surely call for this Court's review.

The Court below refused to consider competent evidence produced during the course of a lengthy trial, and decided the major factual question by applying a legal presumption contradicted by the evidence. Such a simple formula is likely to prove to be an attraction to a beleaguered judiciary in many complex cases. Petitioner submits that substantial justice demands more.

4. The rejection of the unimpeached and uncontroverted testimony of a witness as to the dates upon which he valued the shares in issue, and the substitution by the Court of its opinion as to when he valued such shares is such egregious legal error as to require the exercise of this Court's supervisory jurisdiction under Rule 19.

This Court in *The Conqueror,* 166 U.S. 110 (1897), at 131, held:

> "While there are doubtless authorities holding that a jury (and in this class of cases the court acts as a jury) has no right arbitrarily to ignore or discredit the testimony of unimpeached witnesses so far as they testify to facts, and that a willful disregard of such testimony will be ground for a new trial, no such obligation attaches to witnesses who testify merely to their opinion;***."

Thus as a matter of law the Court below, acting as it did in this proceeding as a jury, may not reject the unimpeached and uncontradicted testimony of a witness as to a fact and substitute therefor its opinion. See also *Chesapeake & Ohio Railway Company* v. *Martin,* 283 U.S. 209, 216-217 (1931). But this is precisely what it did when it rejected the testimony of petitioner's witness as to a fact—the date as of which he valued the shares in issue.

Findings 223-224 (pp. 140-141) recite the witness's testimony that he valued the "749,742 shares of Union Pacific preferred *when issued* *** by contemporaneously governing money rates, related to a 4 percent yield *** [at] *** $100 per share," and the further fact that he valued the "883,357 shares of Union Pacific common stock *** *when issued* *** in the range of $175 to $200 per share."

In addition, the witness upon cross-examination, and during a colloquy with the Trial Judge, reaffirmed that he valued the shares as of their dates of issuance, only taking into account those events which were either then foreseen

or foreseeable. In fact, the witness testified that his value for the common shares as of 1907 (the date as of which the Court below thought he valued such shares) was $275 per share.[11]

Despite the testimony of the witness as to the *fact* that he valued the shares in issue as of their respective issuance dates, and that he valued the preferred shares on the basis of a *contemporaneous* 4 percent money rate, and further that as of 1907 he would have valued the common at $275 per share, the Court below substituted its own opinion as to what it believed to be his dates of valuation.

In the absence of a finding to the contrary, it is clear that the Court's refusal to consider the testimony of the witness on the merits was not based on the lack of credibility as to his dates of valuation. Rather, the Court concluded that the witness's theory was that the reorganization ended in 1907 (Finding 225(d), p. 141), and thus it refused to consider his testimony because:

> "The valuations by plaintiff's expert were thus valuations as of 1907, not as of 1898 and not as of 1898 taking in account then foreseeable events. *Only if one could in 1898 foresee all events to 1907 could his valuations be described as valuations as of the earlier date taking into account future events so far as then foreseeable.*" [Finding 226, Opinion, p. 141] [Emphasis supplied.]

However, in so concluding, the Court ignored his testimony as to the dates upon which he made his valuation and substituted therefor its opinion as to when it thought such valuations were made. Moreover, the Court's conclusion that the witness's theory was that the reorganization ended in 1907 cannot possibly be dispositive of a valuation made at the beginning of that reorganization.

11. The Court below made no findings with respect to this portion of the testimony.

While the Court found that the witness determined a per share value for the common stock for each of the years 1901-1907 (Finding 225(d), p. 141), it then inconsistently concluded that his valuation was as of 1907. The lack of findings which would serve to impeach the testimony of the witness, the lack of findings as to the foreseen or foreseeable events taken into account by him as of his stated dates of valuation, and the lack of findings as to his annual per share values for the 1901-1907 period, under the rule of *Causby, supra*, call for the rejection of the conclusion that his date of valuation was 1907.

5. The Court below erroneously refused to consider on the merits the testimony of a qualified expert witness even though it adopted as fact virtually the entire substance of his testimony to discredit another expert witness.

A further compelling reason why the decision below invokes this Court's supervisory jurisdiction is the Court of Claims' adoption of virtually the entire substance of the testimony of petitioner's expert witness on valuation[12] for the sole purpose of discrediting defendant's expert witness.

Petitioner can find no precedent for such an arbitrarily selective consideration of evidence. It is submitted that such selectivity departs from the well established rule that "in the ascertainment of value there must be a reasonable judgment having its basis in a proper consideration of all relevant facts." *Havemeyer* v. *U.S.*, 59 F. Supp. 537 (Ct. Cl. 1945), *cert. denied*, 326 U.S. 759 (1945).

Finally, a comparison of the testimony of the witness concerning his method of valuation (Findings 227-234, pp. 141-153) with the Court's findings as to what events were either foreseen or reasonably foreseeable with respect to Union Pacific's reorganization indicates that the Court

12. A point conceded by respondent's counsel in oral argument below.

adopted all the essential elements of the testimony of the witness.[13]

Petitioner submits that the foregoing errors constitute such a departure from accepted standards of judicial regularity as to call for the exercise by this Court of its supervisory jurisdiction over the Court below.

The Bond Discount and Premium Issue

Reasons for Granting the Writ

1. The Court below misapprehended the issue, and erroneously based its decision upon the present day construction of the term "interest."

The issue for decision below was whether, at the time of the enactment of Section 711(a)(2)(B) of the 1939 Code, Congress recognized that bond discount and premium were deductible as interest, and not whether, as the Court below concluded, that bond discount and premium, as costs of borrowing money, should be classified as interest for Federal tax purposes. The Court of Claims, however, in construing Section 711(a)(2)(B) concluded that bond discount is "essentially interest," and further concluded that "unamortized bond expense on bonds reacquired, and call premiums payable and paid at such retirement prior to maturity are no different in principle from amortized bond discount."

In deciding this issue on the basis of a present day construction of the term "interest," the Court of Claims ignored those administrative and judicial authorities ex-

13. Aside from the adoption by the Court of Claims of all of the essential elements of plaintiff's expert's valuation, a good indication of the adoption of his theory is the Court's use of the terms "reconstitution" and "reconstitutive reorganization." See for example Findings 297, p. 172; 298, p. 172; 319(b), p. 180; 355(b), p. 200; 360(b), pp. 202-203; 368(b), p. 209; 397(b), p. 225; 406(b), p. 228; and 407(b), p. 229.

tant at the time of the enactment of Section 711(a)(2)(B) which provided that bond discount was *deductible,* not as "interest," but rather as a "loss" or "expense."

When Section 711(a)(2)(B) was enacted, Regulations 111, Section 29.22(a)-17 provided that discount and premium were *deductible* as an *expense,* while the deduction for interest was separately provided for in Section 23(b) of the Code and Section 29.23(b)(1) of Regulations 111.

This Court in *Commissioner* v. *National Alfalfa Dedrydrating and Milling Co.,* 417 U.S. 134 (1974), nowhere discussed by the Court below, recognized that the confusion of authority on this point was not resolved until 1965, when it stated, at 417 U.S. 145:

> "This Court has recognized debt discount as an additional cost incurred in borrowing money. In Helvering v. Union Pacific R. Co., 293 U.S. 282 (1934) * * *, in considering Article 150 of Regulations 33 (revised 1918), which described bond discount as a 'loss,' to be 'prorated over the life of the bonds sold,' the Court referred to discount not only as a loss but also as 'interest paid for the use of capital procured by a bond issue.' 293 U.S., at 286. More recently, in United States v. Midland-Ross Corp., 381 U.S. 54 * * * (1965), we clarified any ambiguity that may have resulted from the interest-loss approach * * *."

In this regard this Court further stated, at 417 U.S. 147:

> "* * * [T]here has been some descriptive confusion in the regulations, with their references to 'loss' as well as to 'interest,' and, as has also been noted, this Court, in Helvering v. Union Pacific R. Co., 293 U.S. at 286 * * * seemed to describe discount both as 'interest paid for the use of capital' and as 'loss resulting from the funding operation * * *.'"

Moreover, this Court's review of the statutory and administrative treatment of the deduction for discount at 417 U.S. 143-144, clearly establishes that:

1. The Regulations first promulgated under the 1954 Code discussed the *deductibility* of discount under Section 1.61-12(c)(3), a section relating to gross income, and not under Section 1.163-1 relating to the deduction for interest.

2. It was not until 1968, in Treasury Decision 6984, 1969-1 C.B. 38, that administratively the *deduction* for discount was included in the section of the regulations which provided for a deduction for interest.

In the face of such a conceptual ambiguity, as well as a Regulation outstanding during the taxable year in question which described the deduction for bond discount as an expense, not as interest, the Commissioner's failure on audit to require petitioner to make an "interest" adjustment pursuant to Section 711(a)(2)(B) is entirely consistent with the proper construction of the term "interest" at the time that section was enacted. The administrative policy at that time is entitled to some weight in construing the term "interest" as used in the statute. Judicial precedent not formulated by this Court until 1965, or as late as 1974, should not be controlling in determining petitioner's tax liability for 1942.

2. The structure of the statute and its legislative history establish that the Congress did not consider bond discount and call premium interest.

An analysis of the structure of Section 711 and its legislative history clearly indicate that Congress did not intend that bond discount and call premium expense constitute "interest," for purposes of the 50 percent adjustment to the "deduction for interest" required by Section 711(a)(2)(B).

In computing the excess profits tax credit under the invested capital method, for taxable years beginning after December 31, 1939, the statute permitted the inclusion in invested capital of 50 percent of borrowed capital and further provided that "the deduction for interest" with respect thereto was to be reduced by 50 percent in computing excess profits tax net income. At the same time, the statute, for purposes of determining the credit based on the income method, provided that with respect to years in the base period no deductions were to be allowed with respect to bond discount and call premiums. Thus, Congress recognized the distinction between interest and other costs of borrowing money, such as bond discount and call premiums, within Section 711 itself.

This dichotomy of treatment within Section 711, and those other provisions of the Code and Regulations in effect in 1942 as noted above, clearly establish that the Congress, when it enacted Section 711(a)(2)(B), never intended nor could have even considered, that the adjustment called for with respect to the "deduction for interest" required an adjustment on account of bond discount and premium. Accordingly, the holding below is clearly erroneous, and the determination that discount and premium are "essentially interest" is irrelevant to the issue presented.

Any remaining doubts on this issue are resolved by an examination of the legislative history of Section 711 and subsequent excess profits tax laws. In considering the Second Revenue Bill of 1940, the Senate adopted an amendment thereto which would have required the result reached by the Court below. This proposal would have called for, in addition to the adjustment for "interest" already contained in the Bill, the elimination in the excess profits tax years of deductions for "bond discount" and "call premium." S. Rep. No. 2114, 76th Cong., 3d Sess. 12, 1940-2 C.B. 528, 536-7, Appendix A, *infra*, p. 49.

Significantly, the Senate's proposal would have eliminated the deductions for call premium and bond discount in their entirety, *not under the guise of "interest," but rather as "call premium" and "bond discount."* At the same time, in discussing the adjustment for 50 percent of "interest" on borrowed capital, provided for by Section 711(a)(2)(B) under the invested capital method for the excess profits tax years, *the Senate Finance Committee specifically referred to the item to be adjusted as interest.* S. Rep. No. 2114, *supra,* p. 12. The proposal was eliminated by the Conference Committee, which, in H.R. Report No. 3002, 76th Cong., 3d Sess. 44, 46, 1940-2 C.B. 548, 552, stated:

> "(2) The adjustment requiring that certain deductions otherwise allowable on account of the retirement or discharge of bonds, etc., should be excluded from the computation has been eliminated for taxable years after the base period. As retained relative to taxable years in the base period, it has been redrafted so as to make certain that the excluded deduction on account of the issuance of bonds, etc., at a discount relates only to discount unamortized on the date of the retirement or discharge. The ordinary deduction for amortization of bond discount accrued for that portion of the taxable year preceding the retirement or discharge is not to be excluded from the computation."

The Court below erred as a matter of law when it rejected the foregoing "as an ambiguous legislative incident," and further erred when it enunciated a unique rule of statutory construction which would require that all of the underlying reasons for the action of the Congress must be explicitly set forth before any consideration will be given to the action itself. See Slip Opinion, p. 51, where the Court stated it lacked the benefit of the Conference Committee's thinking.

3. The Court erroneously ignored the Korean War Excess Profits Tax Act which mandated that the adjustment sought by respondent below to bond discount and premium be made, but whose legislative history noted that no such adjustment was required under the statute here under construction.

That the Court below erred in construing the statute is further evidenced by the Korean War Excess Profits Tax Act and the commentary thereon. Section 101 of the Excess Profits Tax Act of 1950, 64 Stat. 1137, added Section 433(a)(1)(F) to the Code which provided that, in determining excess profits tax net income, certain deductions otherwise allowable upon the retirement or discharge of bonds were to be disallowed, including the deductions for bond discount and call premium. In this regard, House Report No. 3142, 81st Cong., 2d Sess., which accompanied the enactment of Section 433(a)(1)(F) noted, at page 12; 1951-1 C.B. 187, 195:

> "The net income of the excess profits tax year is also corrected by the elimination of deductions arising out of the retirement at a premium of bonds and other evidences of indebtedness outstanding for more than 6 months. The adjustment was allowed under the World War II law, but only in the correction of the base period net income. * * *" [Emphasis supplied.]

See also in this regard the comment in Mertens that "[n]one of these adjustments was provided for in the World War II statute," 7A *Mertens, Law of Federal Income Taxation,* § 42.44 (Zimet and Weiss Rev.), p. 169, and the further comment made by Mertens in footnote 85 at page 169, that:

> "The adjustment made in respect to excess profits tax taxable years, excluding income from retirement

> or discharge of indebtedness, did not affect expenses and losses from such retirement or discharge, and there was no express provision that the exclusion be reduced by any unamortized discount. [Citation omitted.] The World War II statute did, however, make such an adjustment for expenses, losses, and unamortized discount in respect to excess profits net income *in the base period years.* [Emphasis supplied.]

The refusal of the Court below to consider the aforementioned statute, legislative history and commentary in construing the World War II Act constitutes sufficient grounds for the issuance of the writ now sought.

Moreover, the Court below has violated basic concepts of statutory construction laid down by this Court.

In *Gould* v. *Gould,* 245 U.S. 151 (1917), this Court noted at page 153 that:

> In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government and in favor of the citizen. [Citations omitted.]

Further, in *Hanover Bank* v. *Commissioner,* 369 U.S. 672 (1962), this Court held at page 687 that:

> "A firmly established principle of statutory interpretation is that 'the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses.' *Crane* v. *Commissioner,* 331 U.S. 1, 6, 91 L ed 1301, 1306, 67 S Ct 1047. The statute in issue herein, in plain and ordinary language, evidences a clear congressional

> intent to allow amortization with reference to any call date named in the indenture. Under such circumstances we are not at liberty * * * to add to or alter the words employed to effect a purpose which does not appear on the face of the statute * * *." [Footnote omitted.]

Petitioner submits that the decision below is the result of a method of statutory construction which is in direct conflict with these decisions, and accordingly the writ now sought should issue.

Conclusion

WHEREFORE, it is prayed that, for the foregoing reasons, this petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

Statutes and Treasury Regulations

Internal Revenue Code of 1939:

Sec. 23.—In computing net income there shall be allowed as deductions:

* * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

SEC. 710. IMPOSITION OF TAX. (a) IMPOSITION.—

(1) *General Rule.*—There shall be levied, collected and paid, for each taxable year, upon the adjusted excess-profits net income, as defined in subsection (b), of every corporation (except a corporation exempt under section 727) a tax equal to whichever of the following amounts is the lesser:

(A) 95 per centum of the adjusted excess profits net income, or

(B) an amount which when added to the tax imposed for the taxable year under Chapter 1 (other than section 102) equals 80 per centum of the corporation surtax net income, computed under section 15 or Supplement G, as the case may be, but without regard to the credit provided in section 26 (e) (relating to income subject to the tax imposed by this subchapter) and without regard to 80 per centum of the credit provided in section 26 (h) (relating to credit for dividends paid on certain preferred stock).

(2) Sec. 710 (a) (2) is repealed by Sec. 229 (a) (2), Revenue Act of 1942.

(3) *Taxable Years Beginning in 1941 and Ending After June 30, 1942.*—In the case of a taxable year beginning in 1941 and ending after June 30, 1942, the tax shall be an amount equal to the sum of—

(A) that portion of a tentative tax under this subchapter, computed as if the law applicable to taxable years beginning on January 1, 1941, were applicable to such taxable year, which the number of days in such taxable year before July 1, 1942, bears to the total number of days in such taxable year, plus

(B) that portion of a tentative tax under this subchapter, computed as if the law applicable to taxable years beginning on January 1, 1941, were applicable to such taxable year, but as if the amendments made by sections 105 (a), (b) (other than those relating to dividends on the preferred stock of public utilities), (c), (d), and (e) (1), 202, and 206 of the Revenue Act of 1942 were applicable to such taxable year, which the number of days in such taxable year after June 30, 1942, bears to the total number of days in such taxable year.

* * *

(b) DEFINITION OF ADJUSTED EXCESS PROFITS NET INCOME.—As used in this section, the term "adjusted excess profits net income" in the case of any taxable year means the excess profits net income (as defined in section 711) minus the sum of:

(1) *Specific Exemption.*—A specific exemption of $10,000, and in the case of a mutual insurance company (other than life or marine) which is an inter-insurer or reciprocal underwriter a specific exemption of $50,000;

(2) *Excess Profits Credit.*—The amount of the excess profits credit allowed under section 712; and

(3) *Unused Excess Profits Credit.*—The amount of the unused excess profits credit adjustment for the taxable year, computed in accordance with subsection (c).***

* * *

SEC. 711. EXCESS PROFITS NET INCOME.

(a) *Taxable Years Beginning After December 31, 1939.*—The excess profits net income for any taxable year beginning after December 31, 1939, shall be the normal-tax net income, as defined in section 13(a)(2), for such year except that the following adjustments shall be made:

(1) *Excess Profits Credit Computed Under Income Credit.*—If the excess profits credit is computed under section 713, the adjustments shall be as follows:

* * *

(c) *Income From Retirement Or Discharge of Bonds, And So Forth.*—There shall be excluded, in the case of any taxpayer, income derived from the retirement or discharge by the taxpayer of any bond, debentures, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than 6 months, including, in the case the issuance was at a premium, the amount includible in income for such year solely because of such retirement or discharge;

* * *

(2) *Excess Profits Credit Computed Under Invested Capital Credit.*—If the excess profits credit is computed under section 714, the adjustments shall be as follows:

* * *

(B) Interest.—The deduction for interest shall be reduced by an amount equal to 50 per centum of so much of such interest as represents interest on the indebtedness included in the daily amounts of borrowed capital (determined under section 719 (a));***

* * *

(E) Income from Retirement or Discharge of Bonds, and so Forth.—There shall be excluded, in the case of any taxpayer, income derived from the retirement or discharge by the taxpayer of any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than 6 months, including, in case the issuance was at a premium, the amounts includible in income for such year solely because of such retirement or discharge;

(3) *Taxable year less than twelve months.*—

(A) General Rule.—If the taxable year is a period of less than twelve months the excess profits net income for such taxable year (referred to in this paragraph as the "short taxable year") shall be placed on an annual basis by multiplying the amount thereof by the number of days in the twelve months ending with the close of the short taxable year and dividing by the number of days in the short taxable year. The tax shall be such part of the tax computed on such annual basis as the number of days in the short taxable years is of the number of days in the twelve months ending with the close of the short taxable year.

(B) Exception.—If the taxpayer establishes its adjusted excess profits net income for the period of twelve months beginning with the first day of

the short taxable year, computed as if such twelve-month period were a taxable year, under the law applicable to the short taxable year, and using the credits applicable in determining the adjusted excess profits net income for such short taxable year, then the tax for the short taxable year shall be reduced to an amount which is such part of the tax computed on such adjusted excess profits net income so established as the excess profits net income for the short taxable year is of the excess profits net income for such twelve-month period. The taxpayer (other than a taypayer to which the next sentence applies) shall compute the tax and file its return without the application of this subparagraph. If, prior to one year from the date of the beginning of the short taxable year, the taxpayer has disposed of substantially all its assets, in lieu of the twelve-month period provided in the preceding provisions of this subparagraph, the twelve-month period ending with the close of the short taxable year shall be used. For the purpose of this subparagraph, the excess profits net income for the short taxable year shall not be placed on an annual basis as provided in subparagraph (A), and the excess profits net income for the twelve-month period used shall in no case be considered less than the excess profits net income for the short taxable year. The benefits of the subparagraph shall not be allowed unless the taxpayer, at such time as regulations prescribed hereunder require, makes application therefor in accordance with such regulations, and such application, in case the return was filed without regard to this subparagraph, shall be considered a claim for credit or refund. The Commissioner, with the approval

of the Secretary, shall prescribe such regulations as he may deem necessary for the application of this subparagraph.

(b) *Taxable Years in Base Period.*—

(1) General Rule and Adjustments.—The excess profits net income for any taxable year subject to the Revenue Act of 1936 shall be the normal-tax net income, as defined in section 13 (a) of such Act; and for any other taxable year beginning after December 31, 1937, and before January 1, 1940, shall be the special-class net income, as defined in section 14 (a) of the applicable revenue law. In either case, the following adjustments shall be made (for additional adjustments in case of certain reorganizations, see section 742 (e)):

* * *

(C) INCOME FROM RETIREMENT OR DISCHARGE OF BONDS, AND SO FORTH.—There shall be excluded, in the case of any taxpayer, income derived from the retirement or discharge by the taxpayer of any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than 6 months, including, in case the issuance was at a premium, the amount includible in income for such year solely because of such retirement or discharge;

(D) DEDUCTIONS ON ACCOUNT OF RETIREMENT OR DISCHARGE OF BONDS, AND SO FORTH.—If during the taxable year the taxpayer retires or discharges any bond, debenture, note, or certificate or other evidence of indebtedness, if the obligation of the taxpayer has been outstanding for more than eighteen months, the following deductions for such taxable year shall not be allowed:

(i) The deduction allowable under section 23 (a) for expenses paid or incurred in connection with such retirement or discharge;

(ii) The deduction for losses allowable by reason of such retirement or discharge; and

(iii) In case the issuance was at a discount, the amount deductible for such year solely because of such retirement or discharge;

* * *

(2) CAPITAL GAINS AND LOSSES.—For the purposes of this subsection the normal-tax income and the special-class net income referred to in paragraph (1) shall be computed as if section 23 (g) (2), section 23 (k) (2), and section 117 were part of the revenue law applicable to the taxable year the excess profits net income of which is being computed, with the exception that the capital loss carry-over provided in subsection (e) (1) of section 117 shall be applicable to net capital losses for taxable years beginning after December 31, 1934. Such exception shall not apply for the purposes of computing the tax under this subchapter for any taxable year beginning before January 1, 1943.

SEC. 712. EXCESS PROFITS CREDIT—ALLOWANCE.

(a) DOMESTIC CORPORATIONS.—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. For allowance of excess profits credit in case of certain reorganizations of corporations, see section 741.

* * *

SEC. 714. EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL.

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715 is:	The credit shall be:
Not over $5,000,000	8% of the invested capital.
Over $5,000,000, but not over $10,000,000	$400,000, plus 7% of the excess over $5,000,000.
Over $10,000,000, but not over $200,000,000	$750,000, plus 6% of the excess over $10,000,000.
Over $200,000,000	$12,150,000, plus 5% of the excess over $200,000,000.

SEC. 715. DEFINITION OF INVESTED CAPITAL.

For the purposes of this subchapter the invested capital for any taxable year shall be the average invested capital for such year, determined under section 716, reduced by an amount computed under section 720 (relating to inadmissible assets). If the Commissioner finds that in any case the determination of invested capital, on a basis other than a daily basis, will produce an invested capital differing by not more than $1,000 from an invested capital determined on a daily basis, he may, under regulations prescribed by him with the approval of the Secretary, prc ide for such determination on such other basis. (For computation of invested capital in case of foreign corporations and corporations entitled to the benefits of section 251, see section 724.)

SEC. 716. AVERAGE INVESTED CAPITAL.

The average invested capital for any taxable year shall be the aggregate of the daily invested capital for each day

of such taxable year, divided by the number of days in such taxable year.

SEC. 717. DAILY INVESTED CAPITAL.

The daily invested capital for any day of the taxable year shall be the sum of the equity invested capital for such day plus the borrowed invested capital for such day determined under section 719.

SEC. 718. EQUITY INVESTED CAPITAL.

(a) DEFINITION.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) MONEY PAID IN.—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) PROPERTY PAID IN.—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115 (l) for determining earnings and profits;

(3) DISTRIBUTIONS IN STOCK.—Distributions in stock—

(A) Made prior to such taxable year to the extent to which they are considered distributions of earnings and profits; and

(B) Previously made during such taxable year to the extent to which they are considered distributions of earnings and profits other than earnings and profits of such taxable year;

(4) EARNINGS AND PROFITS AT BEGINNING OF YEAR.—The accumulated earnings and profits as of the beginning of such taxable year;

* * *

SEC. 719. BORROWED INVESTED CAPITAL.

(a) BORROWED CAPITAL.—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus,

* * *

Treasury Regulations Under the 1939 Code:

REG. 103, SEC. 19.23(b)-1. INTEREST.—Interest paid or accrued within the year on indebtedness may be deducted from gross income, except that interest on indebtedness incurred or continued to purchase or carry obligations, such as municipal bonds, Panama Canal loan 3 percent bonds, or (in case of a taxpayer not an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from tax, is

not deductible. Interest paid or accrued within the year on indebtedness incurred or continued to purchase or carry *(a)* obligations of the United States issued after September 24, 1917, the interest upon which is not wholly exempt from the taxes imposed by chapter 1 or *(b)* (in the case of an original subscriber) obligations of the United States issued after September 24, 1917, the interest upon which is wholly exempt from the taxes imposed by chapter 1, is deductible in accordance with the general rule.

Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but are treated as rent if the ground rent is irredeemable and in such case are deductible only to the extent they constitute a proper business expense.

Interest calculated for cost-keeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income. (See, however, section 121 and *section 19.22(a)-18.*) In the case of banks and loan or trust companies, interest paid within the year on deposits such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company may be deducted from gross income. As to other amounts of interest not deductible under section 23 (b), see section 24 (c).

REG. 111, SEC. 29.22(a)-17. SALE AND PURCHASE BY CORPORATION OF ITS BONDS.—

* * *

(3) *(a)* If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. *(b)* If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet deducted) is a deductible expense for the taxable year. *(c)* If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is gain or income for the taxable year.

Treasury Regulations Under the 1954 Code:

REG. SEC. 1.61-12 INCOME FROM DISCHARGE OF INDEBTEDNESS.

* * *

(c) Sale and purchase by corporation of its bonds.

* * *

(3) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. If the corporation purchases any of such bonds at a price in excess of the issuing price plus any amount of discount already deducted, the excess of the purchase price over the issuing price plus any amount of discount already deducted (or over the face value minus any amount of discount not yet

deducted) is a deductible expense for the taxable year. If, however, the corporation purchases any of such bonds at a price less than the issuing price plus any amount of discount already deducted, the excess of the issuing price, plus any amount of discount already deducted (or of the face value minus any amount of discount not yet deducted), over the purchase price is income for the taxable year.

REG. SEC. 1.163-1 INTEREST DEDUCTION IN GENERAL.

(a) Except as otherwise provided in sections 264 to 267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income.

(b) Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Payments of Maryland or Pennsylvania ground rents are deductible as interest if the ground rent is redeemable, but are treated as rent if the ground rent is irredeemable and in such case are deductible only to the extent they constitute a proper business expense.

(c) Interest calculated for costkeeping or other purposes on account of capital or surplus invested in the business which does noot represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing taxable income. (See, however, section 583.) In the case of banks and loan or trust companies, interest paid within the year on deposits, such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company, may be deducted from gross income.

Congressional Committee Reports

SENATE REPORT NO. 2114, 76TH CONGRESS, 3RD SESSION 12, 1940-2 C.B. 528, 536-7.

SECTION 711. EXCESS-PROFITS NET INCOME.

* * *

Under the bill, as reported by your committee, the adjustments to normal-tax net income in computing the excess profits net income which were provided in the House bill are retained, but certain changes have been made therein and certain additions made thereto, as follows:

* * *

(3) A new adjustment has been added, applicable whether the excess-profits credit is computed under the income or invested capital plan and to taxable years in the base period as well as to taxable years under the excess-profits tax, requiring that any deductions otherwise allowable on account of the retirement or discharge of indebtedness shall be disallowed if the taxpayer's obligation has been outstanding for more than 18 months. The amounts so to be disallowed include the deduction otherwise allowable under section 23(a) for expenses paid or incurred in connection with such retirement or discharge (including any premium paid upon any such retirement or discharge), the deduction for losses otherwise allowable in such connection, and the deduction otherwise allowable on account of the issuance of the bonds or other evidence of indebtedness at a discount.

* * *